# Turning Inflation Into Wealth Mini-Course

## Reading Three:

## Turning 10% Inflation Into A 27% Benefit



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In this reading we will meet a ravenous Beast that goes by the name of Substantial Inflation, and find out just how difficult it is to keep this Beast from shredding our investment portfolios and consuming our real net worth. Next, we're going to find out how the exact same inflationary conditions which create the Beast, also simultaneously and necessarily create a ravishing Beauty. An easily available Beauty with a most desirable figure, for she generates after-tax and after-inflation benefits that are equivalent to a conventional investment earning 27% per year. As we continue to mangle our fairy tale metaphors, we will pair Beauty up with a Prince, and find out how our portfolios can live happily ever after.

To paint the pictures of Beauty and the Beast, we will be using some very simple equations. If you are not into equations – and most people aren't – don't worry, you don't need to follow them, the points will be explained in the text and by example as well. The reason for the equations is to clearly show upfront that there are no "smoke and mirrors" involved in the remarkable numbers we will be reviewing in this article. There is nothing controversial or even advanced in the math, the returns shown given the assumptions are nothing more than elementary finance, and the simple equations can be easily followed by any financial analyst, accountant or economist.

Let's start with the Beast, and a question – what if real inflation is 10% or more? Some people might say this is a very good question for the next several years, when we look at such longstanding issues as the budget and trade deficits, or paying for promises made to

Boomers. This danger has of course grown much worse as the Fed and Congress have gotten in the habit of creating trillions of dollars out of thin air (essentially), trying to throw as much money as possible at the bailout of Wall Street and stimulus packages, all with no concern for how to pay for them. There are numerous discussions of the reasons to fear inflation elsewhere, in this article we will instead take some quick looks at possible solutions.

**The Ravaging Beast:**

**10% / (100% – 40%) = 16.7%**

The simple equation above is a picture of the Beast, and it is an ugly Beast indeed. The equation calculates the investment return we have to earn in order to merely stay even with inflation. Not really make any money, just run in place and keep our wealth worth the same in inflation-adjusted terms. The simplest way to view this return is to say that if the value of our money declines 10% each year because of inflation, then we must earn 10% per year just to keep up. Unfortunately, in today’s investment environment there are no widely available ways to earn anything close to a ten percent risk-free yield.

The full situation is much worse. Because the relationship between inflation and taxation is one of the more unfair aspects of life. Government policies create inflation. That inflation creates the illusion of income. The illusion of income is then fully taxed by the government. These taxes apply to assets as covered in the previous reading, however, they also apply to interest payments, dividends, capital appreciation, rental payments, or other income sources.

So our illusory 10% yield, that is really just keeping pace with inflation, is taxed by the government with most forms of investments. If our combined state and federal marginal tax bracket is 40%, then we lose 4% of our yield, meaning our after-tax yield is only 6%. Therefore, even an investment yielding 10%, in an environment of 10% inflation, would only be locking in a 4% annual loss in real purchasing power terms.

This brings us back to our Beast equation above. To stay even with 10% inflation, we have to earn an after-tax yield of 10 percent. So we divide inflation by one minus our marginal tax rate, and find that it takes a 16.7% rate of return to stay even with 10% inflation. As an example, if we invest $100,000, then we lose $10,000 (which is 10%) of the real value of the principal amount of our investment to inflation the first year. We must earn $16,700 in income, which is taxed at a rate of 40%, meaning taxes take $6,700 of our earning. Ten thousand dollars of lost purchasing power, plus $16,700 in nominal income, less $6,700 in taxes all add up to zero, meaning we truly do have earn almost 17% to just tread water and maintain the purchasing power of our savings!

**$100,000 Investment**

| | |
|---|---|
| ($10,000) | Inflation loss (10%) |
| $16,667 | Pre-tax earnings (17%) |
| ($6,667) | Taxes paid (40%) |
| $0 | Economic Gain |

Where, exactly, do you invest today to earn a 17% rate of return? Inflation truly is a Beast, particularly when inflation is not priced into the market yield levels, as is the current case.

**A Tantalizing Beauty:**

**[-6.5% X (100% – 40%)] + 10% = 6.1%**

To uncover the alluring Beauty that can be found within the inflationary Beast, let's put some numbers to the equation above. Once again, we will assume that inflation is 10%. This time, we will then assume that you have borrowed $100,000 at a 6.5% interest rate (approximately the average cost of a 30-year fixed rate mortgage over the last few years). This means that you pay $6,500 in interest payments for the year. However, 10% inflation has reduced the principal value of what you owe by 10%, from $100,000 down to $90,000 in real dollars, meaning in economic terms you have experienced a $10,000 gain over that year. Subtract the $6,500 you paid in interest from the $10,000 of economic gain, and you are ahead $3,500.

However, government tax policy does not recognize inflation. The government does not see that you are ahead $3,500 in real, purchasing power terms. What the government sees is that you paid interest. The $6,500 interest expense is deductible against current income, which at a marginal combined rate of 40%, is equal to a $2,600 reduction in taxes paid.

So, we start with a $10,000 economic gain from inflation reducing the real principal value of our debt. We subtract $6,500 in interest payment expenses. We then take advantage of the government's inflation blindness to add $2,600 in tax savings by deducting what is effectively an imaginary cost. We don't declare our economic gain at all, and the government does not see it. When we add all the numbers up, we are ahead by $6,100.

**$100,000 Borrowing**

| | |
|---|---|
| $10,000 | Inflation gain (10%) |
| ($6,500) | Interest Expense (6.5%) |
| $2,600 | Taxes saved (40%) |
| $6,100 | Economic Gain |

The 6.1% after-inflation and after-tax gain shown above is an example of turning adversity into opportunity. Are interest rates far too low compared to the risks to the dollar, both domestically and internationally? Then instead of complaining about the low asset yields, we lock in low costs instead, and go short the dollar on a long-term and tax-advantaged basis, as one component of an overall asset/liability management strategy.

**Beauty's Abundant Attractions**

For comparison's sake, how much would we need to earn using a normal, fully taxable investment in order to equal Beauty's gain? We use our Beast equation from above, and find out that in order to earn $6,100 in real terms, we would need to earn $26,833 in nominal terms. That is, we invest $100,000, and inflation costs us $10,000 of the value of our investment. We cannot deduct that loss, because the government does not see it. What the government sees is $26,833 in earnings, and they want their taxes on the entire amount, even though much of the earnings are an illusion caused by trying to keep up with government fiscal policy. So we pay real taxes of 40% which equals $10,733, and we end up with a real gain of $6,100.

**[26.8% X (100% - 40%)] – 10% = 6.1%**

| **$100,000 Investment** | |
|---|---|
| ($10,000) | Inflation loss (10%) |
| $26,833 | Pre-tax earnings (27%) |
| ($10,733) | Taxes paid (40%) |
| $6,100 | Economic Gain |

So, if inflation averages 10% over let's say, the next ten years, then we would have to actually realize pre-tax gains of almost 27% per year from our investment portfolio, to experience the same economic benefit of a 6.1% after-tax and inflation return, that we would from borrowing at current market, long-term, fixed mortgage rates of around 6.5%. That's amazing – but true.

## Enhancing The Value Of This Reading

Inflation is not a destruction of wealth, but a redistribution of real wealth, and whether you prosper with inflation or it is your wealth that is being redistributed – can be a matter of approach and attitude. If you approach your net worth using the low inflation paradigm of the 1990s and early 2000s, then after-inflation returns become a minor footnote to your decisions, that you sometimes calculate after the real decision making is done. Works great during times of low inflation, but if you take this approach in preparing for inflationary times – you better be pulling in some very high returns, or you'll be losing net worth while paying taxes for the privilege.

Another perspective is that of accepting that the value of money is variable and not fixed, as your starting point for investment decisions. This mindset prepares you to sidestep investment traps, and to instead identify and exploit the accompanying opportunities. (This is also a very good mindset for 2009, for what long-term economic history shows us is that it is during times of financial crisis that the value of money is particularly variable, and the destruction of the value of a lifetime of savings can be cruelly swift.)

With the first approach, we say the dollar is overpriced, and your best protection strategy is to use up your dollars today to pay down your debts with the most expensive dollars possible, so you can be safe from having to repay those debts with cheap dollars later. You then hunker down and try to hold onto your remaining symbols (dollars) with both hands to ride out the storm. This is fairly conventional approach to preparing for turmoil, and at its (unspoken) core, this strategy assumes that the dollar' nature is to be a fixed reservoir of value, and that inflation is an episodic threat to this natural order.

Our alternative approach is to say that the dollar is overpriced, and current low long-term fixed interest rates don't reflect current risks to the dollar. Therefore, you borrow valuable dollars, use them to acquire real assets, let the storm blow, pay off your debts with dollars that are worth quarters, dimes or pennies – and keep the real assets. This strategy is based on a mindset which accepts that the value of a dollar is variable, it has been variable every year of our lives, the fixed value of a dollar is and always has been illusory, and there are powerful reasons to believe that the value of the dollar will be the most variable it has been in our lifetimes over the coming year, and years to follow. In other words, inflation is not a threat to the natural order – rather it is the natural order (for symbolic currencies), particularly during times of crisis. Therefore, you thoughtfully and prudently position your combined asset and liability portfolio in such way that your assets are real, your carefully selected debts blow away with the wind, and the more powerful the inflation, the greater the destruction of the dollar – the more real wealth that flows into your portfolio.

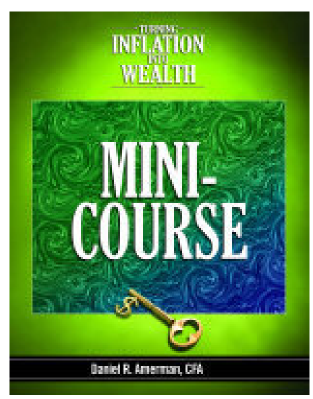
We can protest against the way the world works, and try to beat the Beast of Substantial Inflation through investing in dollar denominated assets. If we do this, we better be good, because anything less than 17% a year means we're losing net worth (under the 10% inflation and 40% tax assumptions shown), and it will take a 27% return on investment, year after year, to come out ahead even 6% a year in real terms. To consistently get those kind of returns, we're going to have to be a financial mastermind, better than most of the legendary investors of financial history.

Or… (contingent upon the same assumptions) we can get that same 6% real return by simply accepting one of the offers for Beauty that currently available from numerous financial institutions. Go short instead of long, and do so in a long-term, low-cost and tax-advantaged manner. Pair Beauty with the real asset Prince of your choice, and let the oncoming changes in the value of the dollar cause real wealth to naturally flow into your net worth, as part of the powerful flow of wealth from creditors to certain types of debtors that has occurred with every major bout of inflation in every nation – instead of building walls to attempt to channel fundamental economic changes away from the value of your symbolic dollars. And of course, for high net worth investors, there is no need for Beauty and her Prince to occupy the main castle, they can also be set up in the guest keep as a refuge if needed, as parts of an overall asset allocation and asset/liability management strategy.

The choice is yours, but do be sure and make the choice, and then take action. For without a wall to withstand the ravaging Beast, or a plan to enjoy Beauty's charms when paired with a tangible asset Prince – then should substantial inflation return, all you will do is lose the value of your dollars. Also keep in mind that Beauty is notoriously fickle, and much of her current historically attractive charms could diminish by next month, next quarter, or next year – if you don't lock in before then.

## The Free Book & Beyond

You are in the early stages of a full length book. We are currently on page 46 of this book, with another 234 pages to go. The book is no teaser – it is a complete and valuable resource in its own right, and we have some fascinating places to go together, as you will learn how to protect what you have built from the current crisis.




However, this free book is also something else – one of the foundation materials for a much larger body of work. An innovative series of books and DVDs that began ten years ago, as I started seeking and developing "out of the box" solutions in anticipation of a time of financial crisis when Baby Boom retirement investments were being pummeled by a one-two combination of asset deflation and monetary inflation, that would destroy conventional financial planning wisdom. (Even if the current crisis hadn't happened, the economic growth in real goods and services never was there to cash out the financial fantasy that was sold to so many tens of millions of people.)

You'll be hearing more about that larger body of work in the readings to come, in the form of discussions appended to the ends of the readings. If you're not the type of person who likes to wait, however, you can find out much more today, by following the link below, and reviewing the on-line brochure for *The Turning Inflation Into Wealth Complete Video Course, Financial Crisis Edition*.


http://mortgagesecretpower.com/Workshop/DVD_Brochure.pdf

## If A Link To This Reading Was Given By A Friend

If you found this article because of a friend's recommendation, then you should know that it is the third of three "eye-openers" that start a free mini-course on Turning Inflation Into Wealth. Much more information on the course and the benefits of the course to you are available by following the link below.

http://mortgagesecretpower.com/Mini%20CourseB.htm

Should you choose to subscribe, a link to the first eye-opener will immediately arrive in your e-mail inbox. That first reading is an unconventional morality tale in which we watch a "pickpocket" in action. We will find that Turning Inflation Into Wealth is far from abstract, as we discover how individuals can use inflation to quite directly take net worth from other individuals. We will then look at the profound but somewhat uncomfortable implications for personal self-defense and profits.

The second eye-opener will arrive in your e-mail inbox in another day or two, and it will show you how the government can use inflation to help itself to your net worth, through converting your after-tax assets into pre-tax income. We'll show how the Dow Jones average can reach 75,000 – and a conventional investor can still lose 73% of their net worth to the one-two combination of government taxes on government created inflation.

You will receive your own copy of this third reading another day or two after that, and then the main part of the course will begin, with delivery on a more leisurely once every two to four day schedule. For, the three eye-openers are just the beginning, and from there we will go on to explore such subjects as finding out how millions (accidentally) turned inflation into wealth in the past, discovering how an understanding of inflation may be your secret weapon if real housing prices fall in your market, the hidden costs of sending extra money in with your monthly mortgage payments, as well as learning how you can go from paying real taxes on illusory profits to illusory taxes on real gains.